DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Jeffrey L. Dorfman, Chief CC:INTL:Br5
Roger M. Brown, Special Counsel to the Assistant Chief Counsel (International - Technical)

SUBJECT:

This Field Service Advice responds to your request for assistance concerning the above-referenced taxpayer. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

The taxpayer =
Products =
The insurer =
Policy A =
Policy B =
ZZ Interest Rate =

Type A Credit =
Type A Credit Rate =
X Consultant =
X thousand =
199X - 199Z =
AA % =
BB% =

CC% =
DD% =
EE% =

FF%	=
GG%	=
HH%	=
JJ%	=
KK%	=
LL%	=
MM%	=
NN%	=
$MM	=
$NN	=

ISSUE

Assuming *arguendo* that interest expenses arising from debt incurred to pay premiums on corporate owned life insurance policies ("COLI") are deductible, whether such interest expenses are directly allocable to the "income" generated from the COLI policies under Treas. Reg. § 1.861-10T(c), or subject to the general allocation rules of Treas. Reg. § 1.861-9T.

CONCLUSION

As a preliminary matter, we note that this memorandum does not address or analyze whether the interest expense is deductible. For a discussion of the deductibility of COLI interest expense, *see* Tech. Adv. Mem. 98-12-005 (March 20, 1998) and Tech. Adv. Mem. 99-01-005 (Sept. 29, 1998). With this proviso, assuming *arguendo* that the "interest" expense arising from the COLI policies is deductible in the first instance, it is inappropriate to allocate under Treas. Reg. § 1.861-10T(c) the interest expense to income generated from these policies for the following reasons: (a) the COLI policies are not term investments; (b) the return on the COLI policies is not reasonably expected to be sufficient to fulfill the payment obligations under the COLI policy loans when measured before tax benefits are taken into account; and (c) the COLI policies do not give rise to interest income (or income that is equivalent to interest). Alone, any one of these reasons would disqualify the COLI interest expense from qualifying for the direct allocation rules of Treas. Reg. § 1.861-10T(c).

FACTS

During the three years at issue (199X-199Z), the taxpayer and its affiliated entities (collectively "the taxpayer") was engaged in the business of producing Products. The taxpayer is not a financial service entity within the meaning of I.R.C. § 904 and the regulations thereunder.

The taxpayer purchased COLI policies from an unrelated insurance company, the insurer ("the insurer"), to insure the lives of approximately X thousand employees.[1] The taxpayer, not the employees or their heirs, is the beneficiary under the COLI policies. The policies give rise to the following economic flows between the taxpayer and insurer:

(1) Payment of premiums by the taxpayer to the insurer. The taxpayer pays premiums *via* policy loans; loading dividends and surrender withdrawals, which are discussed below; and cash outlays. Policy loans, loading dividends, and surrender withdrawals account for substantially all of the premiums due. Premium payments from cash outlays by the taxpayer were projected to be between CC% and FF% during the first three policy years, and between EE% and GG% during the remaining term of the COLI policies. *See* Exhibit H to Form 886-A;

(2) The taxpayer's receipt of tax-free death benefits under the COLI policies;

(3) Policy loans to the taxpayer, which were secured by the cash value of the COLI policies. The cash value was built up by (i) premium payments with the funds borrowed under the policies; (ii) loading dividends; and (iii) interest credits, which are discussed below. During the first three years of the COLI policies, policy loans paid substantially all of the premiums due -- between KK% and LL%. *See* Exhibit H to Form 886-A. Policy loans may be repaid any time during the lifetime of the insured, but become due when the life of the insured ceases;

(4) "Loading dividends," which were *deemed* payments by the insurer to the taxpayer representing the excess of (a) *actual* policy expenses and mortality experience of the COLI policies, over (b) the amount charged under the policies for *estimated* expenses and mortality experience. The premiums were set high enough so that loading dividends were paid (or credited) concurrently with the taxpayer's obligation to pay the premium -- resulting in a circular flow of cash. These dividends were generally large enough to pay a large portion of the premiums due -- about JJ% after the third year of the COLI policies. *See* Exhibit H to Form 886-A. The loading dividends were credited, rather than paid, to the taxpayer by reducing the amount of the premium that would otherwise be due. The dividends were not included in the income of the taxpayer, and contributed to the cash value of the COLI policies;

(5) Surrender withdrawals, which were returns of (a) prior payments of premiums to the taxpayer; and (b) the cash value of the COLI policies. Surrender

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[1] There are two principal groups of COLI policies known as Policy A and Policy B. For purposes of the issue addressed in this Memorandum, we do not believe it is necessary to distinguish between these two groups of policies.

withdrawals generally accounted for approximately HH% of the premiums that were due after the third policy year, and were not included in the income of the taxpayer. *See* Exhibit H to Form 886-A;

(6) "Interest" credits to the taxpayer, of which there were three types:

(a) The first type of interest credit consisted of interest credits to the taxpayer that were not included in the taxable income of the taxpayer. The principal amount on which such interest was computed was the amount of the policy loans which were used to pay premiums to the insurer. In other words, the portion of the cash value of the policies that was attributable to policy loans constituted the principal amount on which such interest was credited. [The cash value of the policies was measured before taking into account the policy loans.]

During the years at issue, the rate on which interest was credited to the taxpayer was based on a formula that used the ZZ Interest Rate as the only variable input.[2] Under the COLI policies, the crediting of interest to the taxpayer was called "Type A Credit," and the rate at which such interest was credited was known as the "Type A Credit Rate";

(b) The second type of interest credit to the taxpayer consisted of interest credits to the taxpayer based on the portion of the cash value that was attributable to actual cash outlays by the taxpayer. This portion of the cash value was negligible in relation to the overall premium charged, and in relation to the interest expenses on the policy loans. [From the available information, the District is unable to determine the exact amount of the policy cash values that were attributable to actual cash outlays by the taxpayer.] The interest was not included in the income of the taxpayer for tax purposes.
Additionally, this second type of interest credit was earned at a rate of between AA% and BB% (depending on the year at issue), while Type A Credit was between MM% and NN%. During each of the particular years at issue, however, the Type A Credit Rate (and the taxpayer's interest expense) was larger

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[2] The formula was [(0% + ZZ Interest Rate) ÷ (1 - ZZ Interest Rate)]. For one of the COLI policies, this formula resulted in a 11.28% rate interest rate **credit** for 1990. *Cf.* footnote 3.

than the rate attributable to interest credits on these unborrowed policy amounts; and

(c) The third type of interest credit to the taxpayer was attributable to instances where there was a delay between the time an insured passed away and death benefits were paid to the taxpayer. Interest, in this circumstance, was included in the income of the taxpayer, but was much less than the taxpayer's claimed interest deductions. The District is uncertain of the exact amounts of these interest credits that were earned, or the rate at which they were credited; and

(7) "Interest" payments on the COLI policy loans, which were computed at a rate 1% higher than the Type A Credit Rate,[3] and were 1.4 to 2.2 times higher than the interest rate the taxpayer paid on its other borrowings. The taxpayer paid COLI interest to the insurer *via* cash payments, loading dividends, and surrender withdrawals, while reporting $NN in interest deductions attributable to the COLI policies.

Without the tax savings arising from the interest deductions, the economic flows from the COLI transaction would not have produced an economic benefit to the taxpayer, as the sum of the economic outflows would been greater than the economic inflows. However, after considering the tax savings associated with the interest deductions, the taxpayer experienced a net, positive economic flow under the COLI policies.

After examining the taxpayer's COLI transactions, the District disallowed the interest deductions arising under the COLI policies, and issued a Form 5701 (Notice of Proposed Adjustment). In the Form 5701, the District adopted an alternative position which provided that if the interest expenses from the COLI policies were deductible, then a portion of the COLI interest expense should have been allocated to foreign source income under Treas. Reg. § 1.861-9T (based on the percent of the taxpayer's foreign assets). On its income tax return, the taxpayer did not allocate the COLI interest expense under Treas. Reg. § 1.861-9T, rather it deducted the expense (only) from U.S. source income. The taxpayer's position appears to be based on Treas. Reg. § 1.861-10T(c), which was contrary to an opinion of a consultant hired by the taxpayer to review the COLI policies. The consultant, X Consultant, concluded that the interest deductions should be

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[3] Thus, the formula was [(0% + ZZ Interest Rate) ÷ (1 - ZZ Interest Rate)] **+ 1%** For one of the COLI policies, this formula resulted in a DD% interest rate **<u>charge</u>** for 1990. *Cf.* footnote 2.

allocated between U.S. and foreign sources under Treas. Reg. § 1.861-9T, rather than directly allocable to income arising under the COLI policies.

The difference between the Treas. Reg. § 1.861-9T and Treas. Reg. § 1.861-10T(c) position is worth approximately $MM of interest deductions allocated to foreign source income. The District states that such an allocation of interest expense to foreign source income will significantly reduce the taxpayer's I.R.C. § 904(a) limitation and place the taxpayer in an excess credit position.

LAW AND ANALYSIS

A. Preliminary Note Regarding the Deductibility of COLI Interest

The District's inquiry relates to the application of Treas. Reg. § 1.861-10T(c) only if interest expense arising from a COLI transaction were deductible in the first instance. Accordingly, this memorandum expresses no opinion and does not purport to analyze whether such interest expense is deductible. *See generally* Tech. Adv. Mem. 98-12-005 (March 20, 1998) and Tech. Adv. Mem. 99-01-005 (Sept. 29, 1998) for a discussion of whether interest expense attributable to a COLI policy may be deducted. [Note, we have not analyzed the degree to which the COLI policies of the taxpayer are similar to the COLI policies analyzed in the Technical Advice Memoranda.] If the interest expense arising from the COLI transaction is not deductible, then Treas. Reg. §§ 1.861-9T and -10T are not applicable. *See* Joint Committee on Taxation, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 ("BLUE BOOK"), pp. 947-8 ("Congress intended that amounts denominated as interest but that are not interest as an economic matter not be treated [as interest for section 864(e) purposes].")

B. Outline of Relevant Regulatory Provisions

Once deductible under I.R.C. § 163, interest expense of a domestic corporation is generally to be allocated between domestic and foreign source income on the theory that money is fungible and interest expense is attributable to all activities and property of the taxpayer regardless of any specific purpose for incurring an obligation on which interest is paid. Treas. Reg. § 1.861-9T(a). Treas. Reg. § 1.861-10T(c)(1) provides one of the exceptions to this rule of fungibility. [Because Treas. Reg. § 1.861-10T(c) was issued on September 9, 1988, it has not sunsetted by operation of I.R.C. § 7805(e), which applies to temporary regulations issued after November 20, 1988.] Treas. Reg. § 1.861-10T(c)(1) provides that interest expense incurred in connection with an "integrated financial transaction" is to be directly allocated to the income generated by the investment funded with the borrowed amounts. Section (c)(2) of this regulation provides a six-prong definition of an integrated financial transaction:

(i) The taxpayer,

(a) Incurs indebtedness for the purpose of making an identified term investment,
(b) Identifies the indebtedness as incurred for such purpose at the time the indebtedness is incurred, and
(c) Makes the identified term investment within ten business days after incurring the indebtedness;

(ii) The return on the investment is reasonably expected to be sufficient throughout the term of the investment to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of principal and interest or original issue discount;

(iii) The income constitutes interest or original issue discount or would constitute income equivalent to interest if earned by a controlled foreign corporation (as described in Treas. Reg. § 1.954-2T(h));

(iv) The debt incurred and the investment mature within ten business days of each other;

(v) The investment does not relate in any way to the operation of, and is not made in the normal course of, the trade or business of the taxpayer or any related person, including the financing of the sale of goods or the performance of services by the taxpayer or any related person, or the compensation of the taxpayer's employees (including any contribution or loan to an employee stock ownership plan (as defined in section 4975(e)(7)) or other plan that is qualified under section 401(a)); and

(vi) The borrower is not a financial services entity (as defined in section 904 and the regulations thereunder).

B. Specific Questions of the District

The District believes that the taxpayer and the COLI policies satisfy several of the prongs of Treas. Reg. § 1.861-10T(c) : Treas. Reg. §§ 1.861-10T(c)(2)(i)(B) & (C) (relating to identification requirements); Treas. Reg. § 1.861-10T(c)(2)(v) (the investment does not relate to the operation and normal course of trade or business); and Treas. Reg. § 1.861-10T(c)(2)(vi) (the taxpayer is not a financial service entity). The District seeks guidance on the remaining parts of the "integrated financial transaction" definition in Treas. Reg. § 1.861-10T(c):[4]

- Concerning Treas. Reg. § 1.861-10T(c)(2)(i)(A) (providing that the debt is incurred for the purpose of making an identified term investment), the District is uncertain whether the COLI policies are term investments;

- Concerning Treas. Reg. § 1.861-10T(c)(2)(ii) (providing that the return on the investment is reasonably expected to be sufficient to fulfill the payment obligations of the loan agreement), the District is uncertain whether this test is applied with or without regard to the tax benefits generated from the COLI policies;

- Concerning Treas. Reg. § 1.861-10T(c)(2)(iii) (providing that the income from the investment constitutes interest or income equivalent to interest if earned by a CFC (as described in Treas. Reg. § 1.954-2T(h))), the District is unclear whether the income generated by the COLI policies satisfies the interest income or equivalent requirement; and

- Concerning Treas. Reg. § 1.861-10T(c)(2)(iv) (providing that the investment must mature within 10 days of incurring the debt), the District is unclear how to apply the 10-day requirement.

C. Responses to Specific Requests

The following are our responses to the specific questions raised by the District:

1. Term Investment

Concerning Treas. Reg. § 1.861-10T(c)(2)(i)(A) (providing that the debt is incurred for the purpose of making an identified term investment), a term investment is intended to mean an investment that will mature on a specific date, rather than continue indefinitely. *See, e.g.,* Treas. Reg. § 1.861-10T(c)(4) examples 1 and 3. The word, investment, is intended to have its commonly understood meaning, which is an expenditure to acquire an asset in order to produce revenue or appreciation in excess of the amount invested. *See* BLACKS LAW DICTIONARY (WEST) (DELUXE 6TH ED. 1990); WEBSTER'S II NEW RIVERSIDE DICTIONARY (RIVERSIDE) (1984). Under the facts

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[4] As is more fully discussed below and contrary to the District's initial conclusions, we do not believe the taxpayer satisfies Treas. Reg. §§ 1.861-10T(c)(2)(i)(C), (c)(2)(v).

at hand, the COLI policies do not qualify as term investments as contemplated by Treas. Reg. § 1.861-10T(c) for two reasons.

The first reason is that the taxpayer's COLI policies are not investments. This is because the policies were not intended to generate revenue or appreciation in excess of the amount invested. In fact, the cash flows from the COLI policies were projected to be negative before consideration of the benefits associated with the tax deductions for interest expenses. Further, as is more fully discussed below, the measurement of cash flow for tax purposes must be made <u>before</u> tax benefits are considered.

The second reason why the COLI policies are not term investments relates to the intent behind the creation of the direct allocation rule of Treas. Reg. § 1.861-10T(c). The rule was intended to address the situation where a borrowing was incurred to acquire an asset that produced a stream of interest income. *See* I.R.C. § 864(e)(7)(B); Treas. Reg. § 1.861-10T(c)(4) examples 1 and 3. In such a situation, the interest expense is more properly traced to the interest income (or equivalent thereof) generated by the asset, rather than being treated as fungible and allocated across the assets and activities of the taxpayer. The COLI policies do not produce *taxable* income (death benefits are not taxable under I.R.C. § 101(a)); nor do they produce *interest* income (as is more fully discussed below). Rather, the COLI transactions were structured in order to generate circular cash flows that, when considered in their totality, recycled the taxpayer's own funds rather than generating income for it.

Because the requirements of Treas. Reg. § 1.861-10T(c) are conjunctive rather than disjunctive, and because the Treas. Reg. § 1.861-10T(c)(2)(i)(A) requirement is not met, the COLI interest must be allocated pursuant to the general allocation rules of Treas. Reg. § 1.861-9T. However, for the sake of a complete analysis and to address the District's specific questions, we will analyze the remaining parts of direct allocation rules of Treas. Reg. § 1.861-10T(c) to illustrate their proper interpretation and application in the COLI context (again, assuming the deductibility of interest is not at issue).

2. <u>Sufficient Return on Investment</u>

Concerning Treas. Reg. § 1.861-10T(c)(2)(ii) (providing that the return on the investment is reasonably expected to be sufficient to fulfill the payment obligations of the loan agreement) and the District's question as to whether this test is applied on a pre- or post-tax basis, one must measure the adequacy of the return on a pre-tax basis. Alternatively stated, the return on the investment must be measured aside from the tax benefits generated from the interest expense deduction. *See, e.g.,* Treas. Reg. § 1.861-10T(b)(3)(iii) ("Cash flow" for the purposes of the direct allocation of interest expense from *qualified nonrecourse indebtedness* to income generated from property is "computed by subtracting cash disbursements excluding debt service from cash receipts."). *See generally* Rev. Rul. 81-149, 1981-1 C.B. 77.

This approach is consistent with the cases which provide that a transaction giving rise to a deduction must have economic substance separate and distinct from the benefits achieved from a tax reduction. For example, in *Goldstein v. Commissioner*, 364 F.2d 734 (2nd Cir. 1966), *aff'g* 44 T.C. 284 (1965), *cert. denied*, 385 U.S. 1005 (1967), the taxpayer borrowed funds from two unrelated banks at a 4% interest rate to purchase a Treasury bond yielding 1½%. Like the case at-hand, the taxpayer and her advisors anticipated a pre-tax loss, but an after-tax profit due to the interest deductions. The court held that the appropriate analysis was to consider the economic profit potential <u>before</u> tax considerations and denied deductions for interest. *Id.* at 740 - 42. *Accord Sheldon v. Commissioner*, 94 T.C. 738, 759 (1990); *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189, 2215-17, 2227 (1997), *aff'd in relevant part*, 157 F.3d 231 (3rd Cir. 1998), *cert. denied*, 67 U.S.L.W. 3585 (U.S. 1999); *Yosha v. Commissioner*, 861 F.2d 494, 498 (7th Cir. 1988); *Knetsch v. United States*, 364 U.S. 361, 366 (1960); *Soriano v. Commissioner*, 90 T.C. 44, 54 (1988); *Julien v. Commissioner,* 82 T.C. 492, 509 (1984).

Because (a) the measurement of adequacy of the COLI policies' returns is made before consideration of tax benefits, and (b) the return on the COLI policies was <u>not</u> reasonably expected to be sufficient to fulfill the payment obligations under the loan obligation, the Treas. Reg. § 1.861-10T(c)(2)(ii) requirement is not met.

3. <u>Return on Investment is Interest or the Equivalent Thereof</u>

Concerning Treas. Reg. § 1.861-10T(c)(2)(iii) (providing that the income from the investment constitutes interest or income equivalent to interest if earned by a CFC (as described in Treas. Reg. § 1.954-2T(h))), the COLI policies fail to satisfy the interest-income requirement because the income generated by the COLI policies is not interest income (or the equivalent thereof). *See* I.R.C. § 864(e)(7)(B).

Interest is defined as compensation for the use or forbearance of money, and may be likened to "rent" for the use of funds. *Old Colony R.R. Co. v. Commissioner*, 284 U.S. 552 (1932); *Dickman v. Commissioner*, 465 U.S. 330, 337 (1984). Similarly, "income equivalent to interest" includes, but is not limited to, (a) an investment or series of integrated transactions which include an investment, in which the net payments, cash flows, or return predominantly reflect the time value of money; and (b) transactions in which payments or a predominant portion thereof are in substance for the use or forbearance of money, but are not generally treated as interest. Treas. Reg. § 1.954-2T(h)(1), 1988-2 C.B. 257, 277. [The final regulation under Treas. Reg. § 1.954-2(h) provides additional types of income equivalent to interest that are not relevant to the facts of the COLI transaction at issue.]

The economic flows to the taxpayer must be analyzed in order to determine whether the interest income requirement is met:

- Death benefits are not compensation for the use or forbearance of money and do not reflect the time value of money. Consequently, they are not interest income;

- Loading dividends and surrender withdrawals are not interest income (or the equivalent thereof) not only because they were not compensation for the use or forbearance of money, but also because they were merely a (circular) return of same premiums that were "paid" by the taxpayer;

- Concerning interest credits to the taxpayer,

  - The first type of interest credit to the taxpayer, the Type A Credit, is not income for the purposes of Treas. Reg. § 1.861-10T(c). Therefore, it does not satisfy the interest income requirement of Treas. Reg. § 1.861-10T(c)(2)(iii), even though Type A Credit is based on a rate which reflects the time value of money – ZZ Interest Rate. This is because it was not intended to compensate the *taxpayer* for the use or forbearance of its funds, as the COLI policies were designed to result in circular cash flows rather than providing a loan to the insurer. *See Golsen v. Commissioner,* 54 T.C. 742, 753-5, n. 7 (1970), *aff'd,* 445 F.2d 985 (10th Cir. 1971), *cert. denied,* 404 U.S. 940 (1971). [The portion of the premium payments attributable to cash outlays is discussed below.]

  - The second type of interest credit to the taxpayer was interest which was attributable to the part of the policies' cash values that consisted of actual cash payments of the premiums by the taxpayer. This second type of interest credit was negligible in relation to the taxpayer's interest expense attributable to the policy loans, making it unreasonable to allocate all the COLI interest expense to such interest credits. Moreover, for this reason and because the interest credit at issue was primarily related to generating a circular cash flow within the COLI policies rather than compensating the taxpayer for the use or forbearance of any funds extended by the taxpayer, it fails to satisfy Treas. Reg. §§ 1.861-10T(c)(2)(ii) and (iii). *See Golsen, supra.*

  - The third type of interest credit was attributable to instances where there was a delay between the time an insured passed away and the time death benefits were paid to the taxpayer. This type of interest credit was not part of the COLI plan, as it was intended solely as compensation for the delay in the payment of certain amounts due (death benefits). Additionally, like the second type of interest credit, it was also negligible compared to the claimed interest expenses. Accordingly, this type of interest does not satisfy the requirements of Treas. Reg. § 1.861-10T(c)(2)(ii).

4. <u>10-Day Maturation Requirement</u>

The last issue raised by the District relates to Treas. Reg. § 1.861-10T(c)(2)(iv)'s requirement that the investment mature within 10 days of the debt to which the interest expenses relate. Because the COLI policies are not investments for the reasons discussed above, this last prong of the Treas. Reg. § 1.861-10T(c) test is not satisfied. Moreover, for this reason, we would like to advise the District that contrary to its initial conclusion, two other prongs of the Treas. Reg. § 1.861-10T(c) requirements are not satisfied: Treas. Reg. § 1.861-10T(c)(2)(i)(C) (identifying the term investment); and Treas. Reg. § 1.861-10T(c)(2)(v) (requiring that the investment not relate to the normal course of a taxpayer's business). This is because these prongs also require that the transaction constitute an investment.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

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If you have any further questions, please call 202-622-3870.

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CC: